No. 7788

In the United States Circuit Court of Appeals for the Ninth Circuit

Philip N. Lilienthal, petitioner

v.

Commissioner of Internal Revenue, respondent

ON PETITION FOR REVIEW OF DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The only previous opinion in this case is the unreported memorandum opinion of the Board of Tax Appeals (R. 16–23).

JURISDICTION

This appeal involves a deficiency of income tax for 1927 in the amount of $38,107.54, and is taken from a decision of the Board of Tax Appeals entered September 29, 1934 (R. 24). The case is brought to this Court by petition for review filed December 17, 1934 (R. 24–30), pursuant to the provisions of Sections 1001–1003 of the Revenue Act of 1926, c. 27, 44 Stat. 9, as amended by Section 1101 of the Revenue Act of 1932, c. 209, 47 Stat. 169.

QUESTIONS PRESENTED

1. Where one corporation acquired in excess of 60 percent of the outstanding capital stock of another corporation in exchange for cash and bonds (but no stock), and the latter corporation was not dissolved but continued to operate its business without modification in any way, did the transaction constitute a "reorganization" within the meaning of Section 203 (h) (1) (A) of the Revenue Act of 1926?

2. Assuming that the transaction was a reorganization within the meaning of Section 203 (h) (1) (A) of the Revenue Act of 1926, should the gain realized from the transaction by the taxpayer be recognized to the extent of the fair market value of the bonds received, namely, $312,340, under Section 203 (d) (1) of the Revenue Act of 1924? This depends upon whether the bonds are "securities" within the meaning of Section 203 (b) (2) of the said Act.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Appendix, *infra,* pp. 31–36.

STATEMENT

The facts, as found by the Board of Tax Appeals and adopted from a stipulation before it, are as follows (R. 17–23):

The petitioner is an individual, with his place of business at San Francisco, California, and with his residence at Burlingame, California.

During the entire calendar year 1927 petitioner and Ruth H. Lilienthal were, and continuously since said last-mentioned date have been, husband and wife and living together as such.

Pursuant to the provisions of Section 223, subdivision (b) of the Revenue Act of 1926, petitioner and said Ruth H. Lilienthal elected to make a single joint income-tax return for the calendar year 1927, and in accordance with such election, petitioner, on or about the 14th day of March 1928, filed with the Collector of Internal Revenue at San Francisco, California, a single joint income-tax return for the calendar year 1927, wherein there was reported and included the income of petitioner and of said Ruth H. Lilienthal, his wife, for such calendar year 1927.

Continuously from August 1921, to November 1926, said Ruth H. Lilienthal was the owner of 1,100 shares of the common stock of Southern California Gas Company having a par value of $100 per share. In November 1926, she, in a nontaxable exchange, for said 1,100 shares, received, 4,400 shares of the common stock of said Southern California Gas Company having a par value of $25 per share, and continuously owned said 4,400 shares to November 17, 1927. Said 4,400 shares had a cost basis of $16,500.

In the year 1927 there were two existing corporations, Southern California Gas Company and Midway Gas Company, which were incorporated under the laws of the State of California, on October 5, 1910, and November 11, 1911, respectively.

The Southern California Gas Company was principally engaged in distributing natural and artificial gas to retail and industrial consumers. The Midway Gas Company was principally engaged in purchasing natural gas in the oil fields, transporting it to cities and selling it to distributing companies. Midway sold the bulk of its gas to Southern California Gas Company.

Under date of October 17, 1927, an agreement was entered into between some of the larger stockholders of the Southern California Gas Company and the Midway Gas Company and a Syndicate of Bankers composed of Chase Securities Corporation, Stone and Webster, Hunter, Dulin and Company, and Pynchon and Company, which agreement provided, among other things, that (1) the Southern California Gas Company was to acquire the properties and business of the Midway Gas Company for capital stock and bonds of the Southern California Gas Company, and (2) for the organization of a new corporation which was to acquire all or practically all of the common stock of the Southern California Gas Company and all of the capital stock of the Midway Gas Company for cash and bonds of the contemplated new company.

On October 4, 1927, the Midway Gas Company adopted resolutions authorizing the sale of its properties and business to the Southern California Gas Company. Said resolution provided that it was the plan of the board of directors that "said common capital stock and said bonds of the Southern California Gas Company to be received for Midway Gas Company assets shall be distributed to the stockholders of this corporation when, as, and if received by this corporation and as soon as such distribution may lawfully be made."

On October 17, 1927, the Southern California Gas Company had issued and outstanding 240,000 shares of common stock of a par value of $25 a share, and 182,226 shares of preferred stock of a par value of $25 a share. Both classes of stock had equal share-voting rights. On said date the Midway Gas Company had issued and outstanding 23,264 shares of capital stock of a par value of $100 a share, all fully voting common stock.

On October 31, 1927, the Southern California Gas Company acquired all of the properties and business of the Midway Gas Company as of August 31, 1927, in consideration of a new issue of 80,000 shares of its capital stock of a par value of $25 a share and $2,942,000 face value of a new issue of bonds of said Southern California Gas Company due in 1957, and the assumption of Midway Gas Company's liabilities. Immediately after this transaction and throughout the remainder of 1927, the Southern California Gas Company had outstanding 320,000 shares of common capital stock, and 182,226 shares of voting preferred stock.

In accordance with the terms of the agreement of October 17, 1927, a new corporation, the Southern California Gas Corporation, was organized under the laws of the State of Delaware on November 12, 1927. Said corporation had an authorized capital stock of $16,500,000 consisting of $7,500,000 preferred and $9,000,000 common, all of which was issued and outstanding on November 17, 1927. Under date of November 17, 1927, the Southern California Gas Corporation acquired under the provisions of the contracts of October 17 and November 17, 1927, and certain deposit agreements referred to in said contracts, 23,121 shares out of a total of 23,264 shares of capital stock of the Midway Gas Company, and 239,608 shares out of a total of 320,000 shares of the outstanding common stock of the Southern California Gas Company, for cash and bonds of the said Southern California Gas Corporation.

The Southern California Gas Corporation issued, on November 17, 1927, for the said shares of stock of Midway Gas Company and Southern California Gas Company, bonds having a par value of $24,942,000. Virtually all of the remaining $58,000 face value of bonds of that issue were subsequently issued in the acquisition of the remaining common stocks of the two said companies. The stocks of

Southern California Gas Company and Midway Gas Company, acquired by Southern California Gas Corporation, as herein set forth, were deposited with a trustee as collateral for the bonds issued as partial consideration therefor.

On November 17, 1927, the board of directors of Midway Gas Company declared a dividend of $2,942,000, and paid the same in Temporary Certificates of the First Mortgage and Refunding Gold Bonds, 5%, due 1957, of Southern California Gas Company.

These bonds were sold on November 17, 1927, at 95, and the proceeds therefrom were used by the Southern California Gas Corporation of Delaware in the acquisition of the stock of Midway Gas Company and of Southern California Gas Company, as aforesaid.

On December 10, 1927, Midway Gas Company distributed the 80,000 shares of common stock of the Southern California Gas Company to its stockholders, one of whom was Southern California Gas Corporation, which received, as such stockholder, 79,508 of the 80,000 shares of the common stock of Southern California Gas Company.

Midway Gas Company did no business thereafter, but retained its charter until March 21, 1934, for the purpose of settling its prior years income taxes.

After the acquisition of the 319,116 shares of the common stock of the Southern California Gas Company by the Southern California Gas Corporation, as aforesaid, the Southern California Gas Company continued, and still does continue, its corporate existence. Its operations were enlarged as it then had the gas-gathering and transporting assets formerly owned by Midway Gas Company. There were some changes in its directorate and management.

Pursuant to the agreement of October 17, 1927, as modified by an agreement dated November 17, 1927, said Ruth H. Lilienthal received for her 4,400 shares of common stock of Southern California Gas Company, $260,609.12 cash and bonds of Southern California Gas Corporation of the par value of $339,500 and of the fair market value of $312,340.

The $260,609.12 was the amount of cash payable to said Ruth H. Lilienthal (including proceeds of sale of a fractional bond), after deducting $1.375 per share brokerage commissions, and her share of other expenses of carrying out the transactions.

The petitioner reported in his single joint income-tax return for the calendar year 1927, a profit of $260,609.12, being the amount of cash received by said Ruth H. Lilienthal. Said Ruth H. Lilianthal did not, in 1927, sell or otherwise dispose of the bonds of Southern California Gas Corporation received for her stock.

The respondent adjusted said Ruth H. Lilienthal's income for 1927, by increasing the same in the amount of $295,840, representing the fair-market value of the bonds received, after deducting from such fair-market value the sum of $16,500, representing the cost to said Ruth H. Lilienthal of her stock.

The deficiency letter explained the adjustment as follows (R. 13):

> With reference to the exchange of stock of the Southern California Gas Company, it is held that this transaction does not fall within the provisions of Section 203 (d) (1) of the 1926 Act. For the purpose of determining the amount of gain or loss, the total consideration received for the stock disposed of is the fair-market value of the bonds as of the effective date of the transaction, plus the amount received in cash. Capital net gain therefore has been adjusted * * *.

The Board of Tax Appeals sustained the determination of the Commissioner upon the authority of its prior decision in *J. S. Rippel & Co.* v. *Commissioner,* 30 B. T. A. 1146, which involved the identical facts and issue with respect to another stockholder of the Southern California Gas Company. In that case the Board held that there was no reorganization within the meaning of Section 203 (h) (1) of the Revenue Act of 1926, and that, therefore, the gain derived by the petitioner upon the exchange of stock in one corporation for cash and bonds of the other was recognizable for tax purposes to the extent of both cash and bonds so received.

SUMMARY OF ARGUMENT

The transaction here was not a reorganization within the intendment of the statute. The scheme of the statute is to defer the recognition of gain or loss in any case where an exchange results merely in a change of form and not of substance. The present transaction was not strictly a merger, a consolidation, or something in the nature of a merger or consolidation, within the statutory definition. In construing the language of Section 203 (h) (1) of the Revenue Act of 1926, and the same provision of other acts, the Supreme Court and the Circuit Courts of Appeals have decided that the words "merger or consolidation" in Clause A must not be disregarded.

While the parenthetical clause expands the meaning of those words, it is of first importance that the transaction partake of the nature of a merger or consolidation. In the absence of such a showing, mere literal compliance with the language within the parenthesis is insufficient to exempt the gain derived from an exchange like the instant one. The transaction here comes within the parenthetical clause of A, but the circumstances surrounding the transaction show that it does not represent a consolidation or merger in a real sense.

Here, the taxpayer received no stock in exchange for his own stock but only cash and bonds of the purchasing corporation. Bonds, like promissory notes, are the equivalent of cash and do not satisfy the requirement of the statute for some continuity of interest by the transferor, where other surrounding facts have no resemblance to a merger or consolidation.

The determination of the Commissioner upon the present facts is consistent with the pertinent regulations embodying the administrative construction. Even if it were not, an erroneous administrative construction must yield to the meaning of the statute, as judicially construed.

ARGUMENT

The transaction under which the taxpayer disposed of his stock was not a reorganization within the intendment of the statute, nor were the bonds received "securities" acquired under a nontaxable exchange

Section 203 (a) of the Revenue Act of 1926, *infra*, provides that—

> Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 202, shall be recognized, except as hereinafter provided in this section.

The transaction here involved was a disposition of property which admittedly produced a profit. There is no controversy with respect to the amount of the profit, the sole question being whether the petitioner is free from taxation on part of it by the exceptions contained in other provisions of Section 203. It is, of course, well settled that one claiming an exemption from tax must bring himself squarely within the provisions of the statute under which he claims such exemption. The rule is equally applicable to a taxpayer who claims the benefit of exceptional treatment. *Bowers* v. *Lawyers Mortgage Co.,* 285 U. S. 182, 187.

The exemption on which the petitioner relies is contained in Section 203 (b) (2), as modified by Section 203 (d) (1). Section 203 (b) (2) provides that—

> No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

This provision is qualified by Section 203 (d) (1), which provides—

> If an exchange would be within the provisions of paragraph (1), (2), or (4) of subdivision (b) if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

The word "reorganization" as used in the section is defined in Section 203 (h) (1) (2) as follows:

> The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a

> majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.
>
> The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

From its terms it is plain that the purpose of the statute was to defer the recognition of gain or loss in any case where an exchange results merely in a change of form and not of substance. A corporate transaction may technically involve a sale or exchange and thus have the elements of a "closed" transaction without changing in substance the real ownership of the property involved. In such a case Congress has provided that no gain or loss shall be then recognized for tax purposes and the tax is postponed.

The decision of the Board of Tax Appeals in the instant case is in accordance with the following authorities and is based upon the principle applied by the courts in these cases: *Pinellas Ice Co.* v. *Commissioner,* 287 U. S. 462; *Cortland Specialty Co.* v. *Commissioner,* 60 F. (2d) 937 (C. C. A. 2d), certiorari denied, 288 U. S. 599; *Prairie Oil & Gas Co.* v. *Motter,* 66 F. (2d) 309 (C. C. A. 10th); *West Texas Refining & Development Co.* v. *Commissioner,* 68 F. (2d) 77 (C. C. A. 10th); *Von Weise* v. *Commissioner,* 69 F. (2d) 439 (C. C. A. 8th), certiorari denied, 292 U. S. 655; *C. H. Mead Coal Co.* v. *Commissioner,* 72 F. (2d) 22 (C. C. A. 4th); *John A. Nelson Co.* v. *Commissioner,* 75 F. (2d) 696 (C. C. A. 7th); *Worcester Salt Co.* v. *Commissioner,* 75 F. (2d) 251 (C. C. A. 2d), and *G. & K. Mfg. Co.* v. *Commissioner,* 76 F. (2d) 454 (C. C. A. 4th).

The cases of *Watts* v. *Commissioner,* 75 F. (2d) 981 (C. C. A. 2d), and *Minnesota Tea Co.* v. *Commissioner,* 76 F. (2d) 797 (C. C. A. 8th), relied upon by the petitioner, do not require a like result here because the factual basis of both those decisions is lacking in the instant case. In both the *Watts* and *Minnesota Tea Co.* cases the transferors of stock or properties of the corporation received in exchange therefor stock in the transferee corporation in addition to cash or other property. In the instant case the transferor received only cash and bonds of the transferee corporation in exchange for his stock and it is established that such an exchange does not satisfy the requirement of the statute. Other distinctions between this and the *Watts* and *Minnesota Tea Co.* cases are discussed in greater detail hereinafter.

There is no contention that the facts in this case constitute a reorganization unless they bring the transaction within the scope of subdivision (A) of Section 203 (h) (1), quoted above. The contention here is that since the transferee acquired a majority of the outstanding stock of another corporation the transaction comes within the literal description of the provision and is tax-free. But by the leading case of *Pinellas Ice Co.* v. *Commissioner, supra,* and the above-cited cases following it, it has long been established that such a literal compliance with the language of the statute does not constitute a reorganization. There must be more than a mere acquisition of a majority of the outstanding shares; the transaction must result in some *real semblance to a merger or a consolidation.* Certainly the facts in the instant case cannot be so described. Here, the taxpayer received cash and well-secured mortgage bonds of a fair market value only slightly less than their par. The old corporation was not dissolved, but continued operation of its business without change in corporate structure, capitalization, or otherwise, and is still in existence.

In *Pinellas Ice Co.* v. *Commissioner, supra,* the taxpayer, a corporation, transferred its assets to another corporation for cash and notes. In affirming the conclusion of the lower court that the transfer did not constitute a reorganization, the Supreme Court said (p. 469):

> The paragraph in question directs: "The term 'reorganization' means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation)." The words within the parenthesis may not be disregarded. They expand the meaning of "merger" or "consolidation" so as to include some things which partake of the nature of a merger or consolidation but are beyond the ordinary and commonly accepted meaning of those words—so as to embrace circumstances difficult to delimit but which in strictness cannot be designated as either merger or consolidation. But the mere purchase for money of the assets of one Company by another is beyond the evident purpose of the provision, and has no real semblance to a merger or consolidation. Certainly, we think that to be within the exemption the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes. This general view is adopted and well sustained in *Cortland Specialty Co.* v. *Commissioner of Internal Revenue,* 60 F. (2d) 937,

> 939, 940. It harmonizes with the underlying purpose of the provisions in respect of exemptions and gives some effect to all the words employed.

Likewise, in the *Cortland Specialty Co.* case, *supra,* the taxpayer, a corporation, transferred its assets to another corporation, for cash and promissory notes. Furthermore, it even agreed to and did dissolve. In denying the claimed exemption the Second Circuit Court of Appeals said (pp. 939–940):

> In subdivision (h) (1) (A) a reorganization is defined as *"a merger or consolidation"*, and the subdivision goes on to say that "merger or consolidation" *include* "the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation." If the last clause means that any transfer of "substantially all the properties" of one corporation to another corporation is a reorganization, the position of Cortland is strong; but we do not regard such an interpretation as warranted. * * * Reorganization is defined in subdivision (h) (1) (A) as including "a merger or consolidation." A merger ordinarily is an absorption by one corporation of the properties and franchises of another whose stock it has acquired. The merged corporation ceases to exist, and the merging corpora-

> tion alone survives. A consolidation involves a dissolution of the companies consolidating and a transfer of corporate assets and franchises to a new company. In each case interests of the stockholders and creditors of any company which disappears remain and are retained against the surviving or newly created company. * * * Undoubtedly such statutes vary in the different states particularly in respect to how far the constituent companies may be deemed to survive the creation of the new or modified corporate structure, but we believe that the general purpose of them all has been to continue the interests of those owning enterprises, which have been merged or consolidated, in another corporate form. * * * In defining "reorganization", section 203 of the Revenue Act gives the widest room for all kinds of changes in corporate structure, but does not abandon the primary requisite that there must be some continuity of interest on the part of the transferor corporation or its stockholders in order to secure exemption. Reorganization presupposes continuance of business under modified corporate forms.

This application and construction of the statute was expressly approved by the Supreme Court in the *Pinellas Ice Co.* case and, it is submitted, is conclusive upon the question presented here. The conclusion is inescapable that there must be some continuity of interest more substantial than that represented by mere well-secured promissory notes or bonds. Such secured obligations to pay are the equivalent of cash and do not meet the requirement of the statute and Regulations (Article 1574, *infra*) that "stock or securities" must be received in the exchange.

Furthermore, it has been expressly held by the same Circuit Court of Appeals (Second), which decided the *Cortland Specialty Co.* case, that bonds of a corporation received in such an exchange are not "securities" within the requirement of the Act for a nontaxable exchange. In *Worcester Salt Co. v. Commissioner, supra,* the taxpayer had acquired from a wholly-owned subsidiary (Kerr-Remington Salt Co.) all of the latter's assets in exchange for $680,000 of bonds of the taxpayer. In denying the transaction constituted a statutory reorganization, the court said (p. 252):

> In *Pinellas Ice & Coal Storage Co.* v. *Com'r, supra,* the court pointed out that, to constitute a reorganization, the transaction must at least "partake of the nature of a merger or consolidation", and in *Cortland Specialty Co.* v. *Com'r, supra,* we defined a merger as an absorption by one corporation of the properties and franchises of another. The transaction in the instant case in no sense can be deemed to "partake of the nature of a merger or consolidation." The Kerr-Remington Salt Company had no interest in the petitioner because, like the notes in the Pinellas Case, bonds are merely an evi-

dence of indebtedness and gave the Kerr-Remington Salt Company no interest in the petitioner itself. Continuity of interest is a requisite. *Cortland Specialty Co.* v. *Com'r, supra; Gregory* v. *Helvering, supra; C. H. Mead Coal Co.* v. *Com'r,* 72 F. (2d) 22 (C. C. A. 4).

Certainly, if in the transaction there between two affiliated corporations, with the purchasing corporation already owning the entire capital stock of the transferor, there may not be said to be such a continuity of interest by the ownership of bonds to satisfy the terms of the statute, far less may it be said here to constitute such an interest where the purchasing corporation acquired only a majority interest in the capital stock from certain stockholders with the transferor corporation retaining its own identity, assets, business, and corporate structure.

Even the receipt of preferred stock is insufficient to secure to the transferor that requisite of continuity of interest in the absence of other factors which would bring an exchange within the definition of a merger or consolidation. This was recently decided by the Seventh Circuit Court of Appeals in the case of *John A. Nelson Co.* v. *Commissioner, supra* (now pending on writ of certiorari in the Supreme Court of the United States, No. 61, October Term, 1935). There the taxpayer transferred substantially all its property (with the exception of $100,000 in cash) to another corporation in exchange for $2,000,000 in cash and 12,500 shares of (nonvoting) preferred stock of the purchasing corporation. Although the transaction came literally within the terms of Section 203 (h) (1) (a), and the parties to the transfer had stipulated that a reorganization under the statute had been effected, the court examined the transaction as a whole and denied the claimed exemption. The court said (p. 698):

> The controlling facts leading to this conclusion are that petitioner continued its corporate existence and its franchise and retained a portion of its assets; that it acquired no controlling interest in the corporation to which it delivered the greater portion of its assets; that there was no continuity of interest from the old corporation to the new; that the control of the property conveyed passed to a stranger, in the management of which petitioner retained no voice.
>
> It follows that the transaction was not part of a strict merger or consolidation or part of something that partakes of the nature of a merger or consolidation and has a real semblance to a merger or consolidation involving a continuance of essentially the same interests through a new modified corporate structure. Mere acquisition by one corporation of a majority of the stock or all the assets of another corporation does not of itself constitute a reorganization, where such acquisition takes the form of a

> purchase and sale and does not result in or bear some material resemblance to a merger or consolidation.

The construction and application of the pertinent provision of the statute by the Circuit Court of Appeals for the Tenth and Fourth Circuits, likewise support the decision of the Board in the instant case. Thus, in *Prairie Oil & Gas Co.* v. *Motter, supra,* the entire stock of Olean Petroleum Company was purchased from its stockholders for cash by Prairie Oil & Gas Company, and shortly thereafter Olean transferred all its property to Prairie Oil & Gas Company. Although the contention was made that the acquisition of the Olean stock and assets by Prairie constituted a reorganization, the Tenth Circuit Court of Appeals chose to view the transaction as a whole, and held that there was merely a sale of the assets.

To the same effect is the case of *West Texas Refining & Development Co., supra,* wherein a corporation transferred to another all its assets for cash and a 50 percent stock interest in the transferee. The same court held the transaction not a statutory reorganization and said (p. 80):

> The purpose of section 203, *supra,* was to relieve corporations from profits taxes in cases where there is only a change in corporate form without an actual realization of any gain from an exchange of properties. It is intended to apply to cases where a corporation in form transfers its property, but in

substance it or its stockholders retain the same or practically the same interest after the transfer. See *Cortland Specialty Co.* v. *Commissioner* (C. C. A. 2) 60 F. (2d) 937, 940; *Pinellas Ice & Cold Storage Co.* v. *Commissioner,* 287 U. S. 462, 53 S. Ct. 257, 77. L. Ed. 428; *Id.* (C. C. A. 5) 57 F. (2d) 188.

Similarly, in *C. H. Mead Coal Co.* v. *Commissioner, supra,* and *G. & K. Mfg. Co.* v. *Commissioner, supra,* the Fourth Circuit Court of Appeals gives recognition to the rule that in order to constitute a statutory reorganization the transaction must, in addition to meeting the literal requirement of the language of Section 203 (h) (1) (A), partake of the real nature of a merger or consolidation. In the *Mead Coal Co.* case, there was in fact a merger, or reorganization, with the stockholders of the old company obtaining stock in the new, with a consequent continuity of interest. In the later *G. & K. Mfg. Co.* case the same court held, upon a view of the whole transaction, that even though the selling corporation acquired stock in the purchaser in exchange for its own assets, the surrounding facts of the transaction were insufficient to show a merger or consolidation. Among the controlling facts, the court mentioned that the taxpayer remained in existence, possessed of a substantial amount of money, qualified to engage in active business in its own capacity or through its subsidiaries, and with the intent so to do, so far as the record shows. To a greater degree, in the instant case, the facts reveal a continued business existence on the part of the transferor corporation, with merely a change in the ownership of the majority of its stock and no continuity of interest by its former stockholders.

Clearly, it is submitted, in the light of the foregoing authorities, the conclusion is inescapable that where one corporation merely purchases a majority stock interest in another corporation, in exchange for cash and bonds, with no continuity of interest on the part of the selling corporation, or its stockholders, and the transferor corporation retains its own assets and identity and continues to engage in active business, as theretofore, none of the elements of a merger or consolidation are present and the transaction is in no respect a reorganization within the meaning of the statute. Consequently, any gain realized by the taxpayer in a transaction of this kind is recognizable and may not be deferred for income-tax purposes.

It is well settled that a literal compliance alone with the pertinent provisions of the statute is insufficient to exempt the gain resulting from an exchange. *Gregory* v. *Helvering,* 293 U. S. 465. It is readily apparent from an examination of the foregoing decisions, that upon the facts in the instant case there is far less reason to construe the transaction here as a statutory reorganization than in the authorities relied upon.

The petitioner urges here that because of the reversal of the decisions of the Board of Tax Appeals in the *Watts* and *Minnesota Tea Co.* cases the decision of the Board in the instant case must be unsound. The conclusion does not follow. The facts in the instant case are entirely unlike the cases relied upon by the petitioner and do not support the *rationale* of those decisions, which gave effect to the pertinent Treasury Regulations.

In the *Watts* case three stockholders transferred the entire capital stock of one corporation to another in exchange for *stocks* and bonds of the transferee. The Commissioner and the Board treated the stock so received by the transferors as cash and determined a deficiency upon that basis. The Circuit Court of Appeals reversed the Board and held a statutory reorganization had been effected under either subdivision (3) or (6) of Article 1574, Treasury Regulations 65, promulgated under the same provisions of the Revenue Act of 1924, and which in all essential respects are identical with Treasury Regulations 69, Article 1574, *infra.* The court, likewise, declared the Regulations referred to valid in the light of their legislative history.

It is manifest, however, from an examination of the language of the Regulations applied by the court that the corresponding article of the Regulations in effect under the Revenue Act of 1926 has no application in the present circumstances. The language of the Regulations declares a statutory reorganization to have been effected—

> If two or more corporations reorganize, for example, by—
>
> (3) The sale of the stock of B to A,
>
> (6) The acquisition by A of a majority of the voting stock and a majority of the total number of shares of all other classes of stock of B or of substantially all of the properties of B, or * * * then no taxable income is received from the transaction by corporation A or B if the sole consideration for the transfer of the assets is *stock or securities* of corporation A or B; and no taxable income is received from the transaction by the shareholders of either corporation A or corporation B if the sole consideration received by the shareholders is *stock or securities* of corporation A or B. (Italics supplied.)

Obviously, the taxpayer here cannot qualify under the proviso of the Regulations to subdivisions (3) or (6), nor under any other of the subdivisions included in the Regulations (see Article 1574, *infra*). All of the transactions described in this Article are conditioned upon the receipt of *stock or securities.*

If more light were needful as to the exact intent and scope of the *Watts* decision, it is supplied by the decision of the same court in the *Worcester Salt Co.* case, *supra,* decided two weeks earlier, wherein the court held that bonds, like notes, are merely an evidence of indebtedness and do not give the requisite continuity of interest. This construction of the statute, of course, is consistent with the pertinent Regulations (Articles 1574, 1575, *infra*).

Likewise, the decision of the Eighth Circuit Court of Appeals in the *Minnesota Tea Co.* case is based upon an exchange whereby the transferor corporation received stock in the transferee. It was contended by the Commissioner that, under the circumstances there, a controlling interest (80 percent) was necessary, but this was denied by the court. The court, however, did recognize the necessity for a continuing interest, represented by *stock,* and said (p. 802):

> That requisite is found as an implication from the provisions of Section 112 (b) (3) and (b) (4) relative to the consideration consisting solely of stocks and securities. But those provisions are to be read in connection with Section 112 (d). No particular percentage of the stock of the transferee to be received by the transferor is specified or required. We find no ground for holding that the "continuance of interest" must be of essentially the same interest, or that it must be a controlling interest. The provision for percentage of stock to be received, specified in clause (B) reorganizations, has no application here.

The *Minnesota Tea Co.* and *Watts* cases are now pending upon writs of certiorari in the Supreme Court of the United States (Nos. 174, 184, 185, 186, respectively, October Term, 1935), but from the foregoing discussion, and an examination of those decisions in the light of the Treasury Regulations applicable thereto, it plainly appears that the factual basis of those decisions (receipt of stock by the transferees) is lacking in the present case, and the rule applied has no application here.

Furthermore, the determination by the Commissioner and the decision of the Board of Tax Appeals in the instant case are in accordance with, and not contrary to, the applicable Regulations 69, Articles 1574 and 1575, *infra.* These Regulations do not define a reorganization as having been effected in the absence of continuity of interest represented by stock ownership and other factors partaking of a merger or consolidation. And, even if they so provided, the judicial construction of the statute is controlling (*Pinellas Ice Co.* v. *Commissioner,* and other above-cited cases), and the Regulations would be without effect. *Morrill* v. *Jones,* 106 U. S. 466, 467; *Burnet* v. *Chicago Portrait Co.,* 285 U. S. 1.

Clearly, it is submitted, the bonds received by the taxpayer are not "securities" within the meaning of the reorganization provisions of the Revenue Acts. *Worcester Salt Co.* v. *Commissioner, supra.* These bonds, like the promissory notes in the *Pinellas* and *Cortland Specialty Co.* cases, are mere evidence of indebtedness and an obligation to pay the purchase price of the stock. In the instant case they were issued for the specific purpose of making partial deferred payment on the purchase price of the stock acquired from petitioner and other stockholders (R. 18, 43, 45).

A bond is primarily a promise to pay a sum of money. Black's Law Dictionary, 3d ed., p. 234; *Corbett* v. *Burnet,* 50 F. (2d) 492 (App. D. C.), certiorari denied, 284 U. S. 646; *Mendelson* v. *Realty Mortgage Corp.,* 257 Mich. 442, 241 N. W. 154, 155.

Section 203 (d) (1) directs that where other property or money is received in an exchange, in addition to the property (stocks or securities) permitted by other paragraphs of Section 203 to be received without the recognition of gain, the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property. Since the property permitted by the pertinent provisions of the statute to be received without recognition of gain consists of *stocks or securities only,* and bonds are neither stocks or securities within the meaning of those provisions, it follows that the gain upon them must be recognized under the statute to the extent of their fair market value.

Whether or not the transaction whereby the Southern California Gas Company acquired all the properties and business of the Midway Gas Company in exchange for its new issue of capital stock constitutes a statutory reorganization has no relation to the taxpayer's position here. Even if it were held that such a transaction was a reorganization under section 203 (h) (1), the bonds of this taxpayer were not acquired from a party to that transaction. They were received from the Southern California Gas Corporation, the new Delaware corporation, which was not a party to the transaction between Old Southern and Midway. As heretofore pointed out, the transaction in which they were received was not one within the meaning of section 203 (h) (1) and the exemption granted by section 203 (b) (2) is not available to this taxpayer.

CONCLUSION

The decision of the Board is correct and should therefore be affirmed.

Respectfully submitted.

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APPENDIX

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1926, c. 27, 44 Stat. 9:

> SEC. 203. (a) Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 202, shall be recognized, except as hereinafter provided in this section.
>
> (b) (2) No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.
>
> (d) (1) If an exchange would be within the provisions of paragraph (1), (2), or (4) of subdivision (b) if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.
>
> (h) (1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B)

a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation. * * * (U. S. C. App., Title 26, Sec. 934.)

Treasury Regulations 69:

ART. 1574. *Exchanges in connection with corporate reorganizations.*—Since corporate reorganizations which result only in a change in form and which do not substantially affect the property interests, either of the shareholders or of the corporations, may be required or may be made desirable by business conditions, State laws, or other causes, the statute provides that no gain or loss shall be recognized if, in pursuance of a plan of reorganization, stock or securities in a corporation a party to a reorganization are exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization, or if, in pursuance of a reorganization plan, a corporation a party to a reorganization exchanges property solely for stock or securities in another corporation a party to the reorganization. If two or more corporations reorganize, for example, by—

(1) The dissolution of corporation B and the sale of its assets to corporation A,

(2) The sale of its property by B to A,

(3) The sale of the stock of B to A,

(4) The merger of B into A,

(5) The consolidation of A and B,

(6) The acquisition by A of a majority of the voting stock and a majority of the total number of shares of all other classes of stock of B or of substantially all of the properties of B, or

(7) The transfer by A of all or a part of its assets to B where immediately after the transfer A or its shareholders are in control of B,

then no taxable income is received from the transaction by corporation A or B if the sole consideration for the transfer of the assets is stock or securities of corporation A or B; and no taxable income is received from the transaction by the shareholders of either corporation A or corporation B if the sole consideration received by the shareholders is stock or securities of corporation A or B.

Furthermore, if the reorganization is accomplished by the transfer by corporation A of a portion of its assets to corporation B in exchange for the stock of corporation B, and corporation A distributes to its shareholders the stock of corporation B, no taxable income is realized by the shareholders from the receipt of such stock. (See article 1576.)

In conformity with the principles of ignoring for tax purposes those reorganizations which result merely in a change in form, the statute provides further that the stock received by the shareholders in connection with the reorganization shall have the same basis for the purpose of determining gain or loss from its subsequent sale as the stock surrendered by them, and that the assets acquired by a corporation a party to the reorganization shall have the same basis for determining depletion, exhaustion, wear and tear, obsolescence, and gain or loss from subsequent sale as they had in the hands of the corporation from which they were acquired. (See articles 1596–1598.)

Adequate provision is made in the statute for cases in which income is actually realized by the shareholders in connection with the reorganization through the receipt of cash or property other than the stock of a corporation a party to the reorganization. (See article 1575.) While placing no obstacle in the way of genuine reorganizations, the statute does not allow the use of reorganizations to avoid the tax.

Records in substantial form, showing the basis of the stock or property exchanged, and the amount of property or money received in exchange, must be kept to enable the determination of gain or loss from a subsequent disposition of the stock or property received or exchanged.

ART. 1575. *Exchanges in reorganization for stock or securities and other property or money.*—If stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchange for stock or securities in such corporation or in another corporation a party to the reorganization and other property or money, the gain, if any, to the recipient will be recognized in an amount not in excess of the sum of the money and the fair market value of the other property. No loss from such an exchange will be recognized, however. (See section 203 (f).) If a distribution of property or money in the course of a reorganization is otherwise within the provisions of this paragraph, but has the effect of the distribution of a taxable dividend, there shall be taxed to each distributee (1) as a dividend, such an amount of the gain recognized under this paragraph as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and (2) as a gain from the exchange of property, the remainder of the gain recognized under this paragraph.

Examples.—(1) A, in connection with a reorganization, exchanges in 1925 a share of stock in the X company, purchased in 1918 for $100, for (*a*) a share of stock in the Y company a party to the reorganization, which has a fair market value of $90, and (*b*) $20 cash. The gain from the transaction, $10, is recognized and taxed to A. See article 1596 for the basis for determining gain or loss from a subsequent sale.

(2) The X corporation has a capital of $100,000 and earnings and profits of $50,000 accumulated since February 28, 1913. The X corporation in 1925 transfers all its assets to the Y corporation in exchange for the issuance of all Y's stock and the payment of $50,000 in cash to the shareholders of corporation X. A, who owns one share of stock in X, for which he paid $100, receives a share of stock in Y worth $100 and in addition $50 in cash. A will be liable to the surtax on $50.

If, in pursuance of a plan of reorganization, property is exchanged by a corporation a party to a reorganization for stock or securities in another corporation a party to the reorganization and other property or money, then, if the other property or money received by the corporation is distributed by it pursuant to the plan of reorganization, no gain to the corporation will be recognized. If the other property or money received by the corporation is not distributed by it pursuant to the plan of reorganization, the gain, if any, to the corporation from the exchange will be recognized in an amount not in excess of the sum of money and the fair market value of the other property so received which is not distributed. In either case no loss from the exchange will be recognized. (See section 203 (f).) E.L

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